#### **DEPARTMENT OF STATE REVENUE**

NOTE: The Letter of Findings 02-20140139, as originally published in the Indiana Register on July 29, 2015, at 20150729-IR-045150208NRA, inadvertently included information that is confidential under <u>IC 6-8.1-3-3.5</u>. This document has been revised in order to exclude the confidential information.

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# LETTER OF FINDINGS: 02-20140139 Corporate Income Tax For the Years 2009, 2010, and 2011

**NOTICE:** IC § 6-8.1-3-3.5 and IC § 4-22-7-7 require the publication of this document in the Indiana Register. This document provides the general public with information about the Department's official position concerning a specific set of facts and issues. This document is effective as of its date of publication and remains in effect until the date it is superseded by the publication of another document in the Indiana Register. The "Holding" section of this document is provided for the convenience of the reader and is not part of the analysis contained in this Letter of Findings.

#### **HOLDING**

[Redacted] Company failed to establish that the separate accounting method of calculating the apportionment of the individual entities included in the company's consolidated return was wrong. The Department was justified in recalculating the company's prior year net operating losses. The original consolidated return calculation did not fairly reflect the company's Indiana source income.

#### **ISSUES**

## I. Corporate Income Tax - Consolidated Separate Accounting.

**Authority:** U.S. Const. amend. XIV § 1; IC § 6-3-2-2(I); IC § 6-3-2-2 (m); IC § 6-3-4-14(a); IC § 6-8.1-3-3(b); IC § 6-8.1-5-1(c); IC § 6-8.1-5-2; IC § 6-8.1-5-4(b)(2); 1963 Acts (s) ch. 32, § 204; Dept. of State Revenue v. Caterpillar, Inc., 15 N.E.3d 579 (Ind. 2014); Indiana Dep't of State Revenue v. Rent-A-Center East, Inc., 963 N.E.2d 463 (Ind. 2012); Miller Brewing Co. v. Indiana Department of State Revenue, 903 N.E.2d 64 (Ind. 2009); Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue, 867 N.E.2d 289 (Ind. Tax Ct. 2007); Wabash, Inc. v. Department of State Revenue, 729 N.E.2d 620 (Ind. Tax Ct. 2000); 45 IAC 3.1-1-110; Letter of Findings 04-20140145 (August 1, 2014); Black's Law Dictionary (10<sup>th</sup> ed. 2014).

Taxpayer argues that the audit exceeded its statutory authority in requiring it to report its income on a "consolidated separate accounting basis" and that the audit decision requiring Taxpayer to do so was unjustified.

### II. Tax Administration - Underpayment Penalty.

**Authority:** IC § 6-3-4-4.4(c); IC § 6-3-4-4.1(d); IC § 6-8.1-5-1(c); IC § 6-8.1-10-2.1(a)(2); IC § 6-8.1-10-2.1(a)(3); IC § 6-8.1-10-2.1(d); <u>45 IAC 15-11-2(b)</u>; <u>45 IAC 15-11-2(c)</u>.

Taxpayer maintains that the assessment of a ten-percent underpayment penalty is unwarranted because any purported deficiency in paying its taxes was not due to its negligence or disregard of Indiana's tax laws.

### STATEMENT OF FACTS

Taxpayer consists of twenty affiliates (hereinafter "Taxpayer") which are themselves subsidiaries of a national [Redacted] company. During the years at issue, Taxpayer reported its income by means of Indiana "consolidated" income tax returns.

The consolidated returns included the twenty affiliated companies. Twelve of those companies reported 100 percent of their income to Indiana. These twelve companies reported profits between tax years 2003 through 2011. Nonetheless, on its consolidated returns, Taxpayer reported losses for 2003 through 2011 because three of the consolidated companies incurred substantial losses.

The Indiana Department of Revenue ("Department") conducted an audit review of Taxpayer's business records and tax returns. The audit determined that Taxpayer should have reported its income on a consolidated, separate

accounting basis. The audit's decision resulted in an assessment of additional Indiana income tax. Taxpayer disagreed with the audit's conclusions, the audit's reporting calculation, and the consequent assessment of additional tax. Taxpayer submitted a protest to that effect, an administrative hearing was conducted during which Taxpayer's representative explained the basis for the protest, and this Letter of Findings results.

## I. Corporate Income Tax - Consolidated Separate Accounting.

#### **DISCUSSION**

The issue is whether the audit's decision requiring Taxpayer's affiliates to file on a consolidated, separate accounting basis was justified on the ground that - as originally reported - the standard consolidated filing method did not fairly reflect the Taxpayer's Indiana source income.

In considering Taxpayer's protest and as a threshold issue, it is the Taxpayer's responsibility to establish that the audit decision requiring it and its subsidiaries file on a consolidated, separate accounting basis and the consequent tax assessment is incorrect. As stated in IC § 6-8.1-5-1(c), "The notice of proposed assessment is prima facie evidence that the department's claim for the unpaid tax is valid. The burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made." Indiana Dep't of State Revenue v. Rent-A-Center East, Inc., 963 N.E.2d 463, 466 (Ind. 2012); Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue, 867 N.E.2d 289, 292 (Ind. Tax Ct. 2007). Consequently, a taxpayer is required to provide documentation explaining and supporting his or her challenge that the Department's position is wrong. "[W]hen [courts] examine a statute that an agency is 'charged with enforcing . . . [courts] defer to an agency's reasonable interpretation of [the] statute even over an equally reasonable interpretation by another party." Dept. of State Revenue v. Caterpillar, Inc., 15 N.E.3d 579, 583 (Ind. 2014). Thus, interpretations of Indiana tax law contained within this administrative decision, as well as the preceding audit, are entitled to deference.

### A. Audit Result

## 1. The Consolidated Return as Originally Filed.

In reviewing the 20 subsidiaries doing business in Indiana, the audit found that twelve affiliates apportioned 100 percent of their income to Indiana and consistently reported profits. Those twelve affiliates reported \$156,000,000 in taxable income during 2003 though 2011. Nonetheless, the audit report found that, as reported, three companies ("Company A," "Company B," and "Company C") had a disproportionate effect on the consolidated group:

Despite the profitability of more than half of the operating companies in the Indiana IT 20 returns, the Taxpayer reported consistent net operating losses for the years 2003-2011. The net operating losses reported by [Company A], [Company B], and [Company C] eliminate all of the taxable income of the affiliates with 100[percent] apportionment.

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[T]he total net operating loss reported by these three entities amounted to [1.5 billion dollars] since 2003 is greater than the net operating loss reported by the consolidated group amounting to [1.3 billion dollars]. The difference between these amounts is the profit reported by the other affiliates.

In addition to the fact that the Taxpayer reported no adjusted gross income in Indiana since 2003, and had been consistently reporting losses since 2002, the audit noted that the Taxpayer's 2003 through 2011 corresponding federal tax returns reported six profitable and three loss years. These federal returns included the net income of more than 150 subsidiaries, which included the 20 subsidiaries that filed in Indiana.

The audit also explained that the three entities generating substantial losses for the consolidated group did so despite relatively small Indiana apportionment factors as well as minimal connections to Indiana. For tax years 2009-2011, the loss companies ("Company A," "Company B," and "Company C") reported the following apportionment factors:

- Company A reported an Indiana apportionment percentage ranging from 7.9 percent to 8.69 percent.
- Company B reported an Indiana apportionment percentage ranging from 2.45 percent to 2.64 percent,

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Company C reported an Indiana apportionment percentage ranging from 0 percent to 2.82 percent

The audit report also noted that the three loss companies had limited business activity within Indiana:

[Company A]'s presence in Indiana is due to its ownership interest in [First Partnership] ([less than 20 percent]) and [Second Partnership] ([less than 50 percent]), partnerships that operate in Indiana. [Company B] is [a multi-state company] and [Company C] has a [more than 80] percent ownership interest in [Third Partnership], a partnership that [has nexus] in several states including Indiana.

The audit report explained that the standard consolidated apportionment method produced a distortive effect:

Under the standard apportionment methodology, three companies - each of which has relatively minimal ties to this state - placed the entire consolidated entity into a "loss" position for the years 2003 to 2011. Taxpayer's original return had the effect of converting 12 affiliates - each of which had substantial ties with Indiana (read as 100[percent] apportionment) with over [\$156,000,000] in taxable income over 9 years - into a consolidated entity with [\$61,000,000] in losses over the same period. Such loss is due to the inclusion of the entities each of which had only several million dollars of actual Indiana losses. The net effect of Taxpayer's approach would have been to "import" substantial losses generated outside Indiana into Indiana. For instance, what would have been a 2009 Indiana loss for [Company B] of [\$2,200,000]] would have become, in effect, a [\$77,000,000] Indiana loss as part of the consolidated group.

In other words, the original consolidated returns created a means by which the loss companies imported a disproportionate amount of losses into Indiana, which would not have been possible, had the filed separate Indiana returns.

Based on a review of the originally filed consolidated tax returns, and taking into account the manner in which the consolidated group was generating its continuous losses for nine years, the audit concluded that their "losses under the current filing method distort Indiana taxable income."

# 2. Addressing the Distortion.

Once the auditor determined that the Taxpayer's current filing method distorted the consolidated group's reported income, the auditor considered the filing method which would fairly reflect the Taxpayer's Indiana income. The auditor cited IC § 6-3-2-2(I) and (m) as authority to reapportion the Taxpayer's Indiana income. The audit determined that one specific statutory method would address the distortion and therefore fairly reflect the Taxpayer's income:

If the allocation and apportionment provisions of this article do not fairly represent the taxpayer's income derived from sources within the state of Indiana, the taxpayer may petition for or the department may require, in respect to all or any part of the taxpayer's business activity, if reasonable:

(1) separate accounting;

. . .

In the case of two (2) or more organizations, trades, or businesses owned or controlled directly or indirectly by the same interests, the department shall distribute, apportion, or allocate the income derived from sources within the state of Indiana between and among those organizations, trades, or businesses in order to fairly reflect and report the income derived from sources within the state of Indiana by various taxpayers.

The auditor explained that "[t]he separate computation of adjusted gross income in this audit seeks to neutralize the ability of the huge apportionment numbers of [Company A], [Company B], and [Company C] to distort the 100[percent] apportionment of the majority of the affiliates and therefore 'fairly reflect' Indiana source income." In other words, the auditor determined that separate accounting, as permitted under <a href="IC 6-3-2-2">IC 6-3-2-2</a>(I), was the best apportionment method.

In effect, the audit recalculated Taxpayer's consolidated returns and the consolidated entities' apportionment factors. As the audit report explained, "[t]he separate computation of the adjusted gross income was done as if each affiliate filed separate returns. The adjusted gross income for each affiliate was computed using its own apportionment factors. The resulting adjusted gross income for each affiliate is summed up to form the basis for the consolidated adjusted gross income tax liability for the group."

## B. Taxpayer's Response.

Taxpayer maintains that the audit's decision is supported by neither the facts nor law and that the consequent assessment is erroneous.

### 1. Statutory Basis for Filing a "Simple," Consolidated Return.

Taxpayer cites to IC § 6-3-4-14(a) and <u>45 IAC 3.1-1-110</u> as authority for its position that it is entitled to report its affiliates' income on a simple, consolidated return basis.

In part, IC § 6-3-4-14(a) provides as follows:

An affiliated group of corporations shall have the privilege of making a consolidated return with respect to the taxes imposed by IC 6-3. The making of a consolidated return shall be upon the condition that all corporations which at any time during the taxable year have been members of the affiliated group consent to all of the provisions of this section including all provisions of the consolidated return regulations prescribed pursuant to Section 1502 of the Internal Revenue Code [FN1] and incorporated herein by reference and all regulations promulgated by the department implementing this section prior to the last day prescribed by law for the filing of such return. The making of a consolidated return shall be considered as such consent. In the case of a corporation which is a member of the affiliated group for a fractional part of the year, the consolidated return shall include the income of such corporation for such part of the year as it is a member of the affiliated group. (Emphasis added).

### 45 IAC 3.1-1-110 in part states:

An affiliated group as defined in <u>IC 6-3-4-14(b)</u> may file consolidated returns for Adjusted Gross Income Tax and Supplemental Net Income Tax purposes if the members of the affiliated group consent to follow the provision of <u>IC 6-3-4-14</u> and the regulations established thereunder, including Federal regulations promulgated pursuant to Internal Revenue Code section 1502 which are incorporated by reference in <u>IC 6-3-4-14</u>. The inclusion of a member of an affiliated group in the consolidated return is deemed to be its consent to the consolidated filing. Once an election is made to file consolidated, a taxpayer must obtain written permission from the Department to change from this method of reporting.

Taxpayer maintains the Department is ignoring both the meaning and intent of the Indiana statute and the Department's own regulation. According to Taxpayer, "The auditor has completely ignored the word 'privilege' in Ind. Code § 6-3-4-14(a)." Taxpayer cites to Black's Law Dictionary 1390 (10<sup>th</sup> ed. 2014) for the proposition that a "privilege" constitutes "a special legal right, exemption, or immunity granted to a person . . . . A privilege grants someone the legal freedom to do or not to do a given act." Id.

Taxpayer concludes that, under IC § 6-3-4-14, it has a statutory privilege of "fil[ing] a consolidated return that treats the participating members as one taxpayer."

## Taxpayer summarizes:

The auditor's proposed methodology denied [Taxpayer] the privilege of filing a consolidated return that treats the participating members as one taxpayer and therefore is unlawful. The audit tries to obfuscate this by calling his method a "consolidated separate accounting" method. This is, however, unabashed wordplay, since "consolidated" and "separate" refer to completely opposite concepts. Furthermore, there is no reference in the laws and regulations to "consolidated separate accounting."

## 2. Tax Court's Wabash Decision.

In support of its argument challenging the Department's decision, Taxpayer cites to Wabash, Inc. v. Department of State Revenue, 729 N.E.2d 620 (Ind. Tax Ct. 2000) stating that the court's decision "confirm[s] the statutory right of companies to file consolidated returns under [IC § 6-3-4-14]." In that case, Wabash Inc. appealed from the Department's decision that Wabash Inc. erroneously included its nonresident parent corporation in its consolidated tax return. Id. at 622. The court agreed with the petitioner's contention that the parent company's activities within Indiana exceeded the "mere solicitation standard" and was properly included in the petitioner's consolidated return. Id. at 624. In addition, the court rejected the Department's position that the petitioner should report the consolidated group's income on a "stacked" basis. Id. at 625. In doing so, the court took the opportunity to explain the "stacked computation."

Under this method, [parent company's] return would be computed separately from the rest of the companies listed in Wabash's return by specifically applying the standard formula to each company. That figure would then be stacked on top of taxes computed by using the standard formula applied to the other companies'

consolidated returns to arrive at the taxable income for Wabash, Id.

In rejecting the Department's "stacked" methodology the court pointed out that "[t]he Department has acknowledged that the standard formula is the most accepted and recognized method of computing a company's taxes." Id. The court also noted that "[t]he Department has reiterated its preference for the standard method in a series of revenue rulings where the taxpayer sought to use the stacked method." Id. The court cited to one of those Department rulings:

The basic preference behind a consolidated income tax return is that the group is treated as a single corporation . . . . [A] combined three-factor formula is employed to fairly reflect the income derived from Indiana sources. Id. at 625-26.

The court also cited to another ruling in which the Department stated:

The Indiana Department of Revenue forms [] do not provide for the calculation of income as described by the taxpayer . . . . There are no provisions for separate calculations with a single consolidation to determine Indiana taxable income. Id. at 626.

The court concluded that "[t]he spirit and intent of a consolidated adjusted gross income return is to treat an affiliated group as a single taxpayer" and that the Department failed to justify resorting to an otherwise permissible alternative by establishing that "the standard formula employed by Wabash . . . unfairly reflect[ed] Wabash's Indiana source income." Id.

### 3. Recalculating Net Operating Losses.

In addition to applying the "consolidated separate accounting" to the years under audit, the audit recalculated Taxpayer's 2004 through 2008 prior returns using the same methodology and for the same reasons previously cited. The audit employed "separate accounting" in order to address those reasons. The audit's recalculation of those years resulted in an elimination of approximately \$61,000,000 in net operating losses ("NOLs"). As explained by Taxpayer in its protest:

The auditor recomputed [Taxpayer's] Indiana adjusted gross income tax liability for 2004 through 2008 (years closed to assessment) using his "consolidated separate accounting" or his "separate accounting" method depending on which version or section of the audit report one reads. The recomputed 2004 adjusted gross income was positive . . . . The auditor then applied and used up substantial NOLs from 2002 and 2003 (also years long closed to assessment) against the 2004 revised adjusted gross income-even though 2004 was closed to assessment at the time the Department did this. This results in [Taxpayer] losing NOLs of over \$11 million. Additionally, the Department denied substantial reported NOLs for 2005 through 2008.

Taxpayer claims that the audit's treatment of the NOLs violates that "spirit and intent . . . " of the law and challenges the audit decision that the originally filed 2004 through 2008 returns do not fairly reflect the Taxpayer's Indiana source income. Taxpayer maintains that the "biggest driver of the auditor's conclusion" relate to the NOLs. According to Taxpayer:

The auditor does not question the amount of the NOLs or that they were valid NOLs or that they were incurred by the taxpayers in the consolidated return as filed. Instead [the audit] analyzes the NOLs on a corporation by corporation basis - a separate return basis - rather than analyzing and treating the affiliated group as a single taxpayer as required by law.

. . .

Furthermore, simply because NOLs reduce taxable income and/or there are large denominators (both relied upon the auditor as a basis for his proposed assessment) in a consolidated return does not mean there is a distortion of Indiana source income. It is not uncommon for a taxpayer to have NOLs and/or large denominators. Nothing indicates the activities of the entities included in the consolidated return constituted an abusive tax avoidance scheme such that returns filed during the Years at Issue did not "fairly reflect [Taxpayer's] Indiana source income.

Taxpayer concludes that the Department is without statutory authority to recalculate the 2004 through 2008 prior year returns on a "consolidated separate accounting basis" and thereby deny Taxpayer the benefit of NOLs garnered during those years. As authority, Taxpayer cites to IC § 6-8.1-5-2 which provides in part:

(a) Except as otherwise provided in this section, the department may not issue a proposed assessment under

section 1 of this chapter more than three (3) years after the latest of the date the return is filed, or either of the following:

(1) The due date of the return.

In addition, Taxpayer points to IC § 6-8.1-5-4(b)(2) which provides that "a person must retain [its] books and records . . . for a period of at least three (3) years after the date the final payment of the particular liability was due . . . . "

Taxpayer states that the factual findings within the audit report do not justify treatment of the NOLs by means of the remedy set out in IC § 6-3-2-2(I).

[T]he audit argues that the net operating losses of three entities somehow "distort" Indiana taxable income. However, there is no evidence (or even suggestion) that these losses were not real losses, were somehow overstated, or more importantly that they were not allowable deductions in calculating the adjusted gross income in the consolidated returns filed by Taxpayer. Simply because net operating losses reduce taxable income in a consolidated return does not and cannot mean they "distort" taxable income.

## 4. Constitutional Argument.

Taxpayer suggests the Department's reversal of the NOLs violates the Equal Protection Clause which mandates that no state shall "deprive any person of life liberty or property without due process of law; nor deny to any person within its jurisdiction the equal protection of the laws." U.S. Const. amend. XIV § 1.

[A]djusting NOLs that arose over ten years ago for [Taxpayer], while applying a three-year statute of limitations period for income generating taxpayers [IC § 6-8.1-5-4(b)(2)] also results in disparate treatment between taxpayers with NOLs and income-generating taxpayers in violation of the Equal Protection Clause of the Fourteenth Amendment. The Department already audited the 2002 and 2003 tax years and now seeks to strip [Taxpayer] of NOLs in a closed year by using up the 2002 and 2003 NOLs. By allowing this adjustment, the Department gets a second chance to adjust those years with the additional administrative burdens and costs of the second audit falling on [Taxpayer]. This disparate treatment of taxpayers is not rationally related to a legitimate purpose of the Department.

### 5. Taxpayer's Filing History.

Citing to IC § 6-8.1-3-3(b), Taxpayer sets forth a fifth argument arguing that the Department may not make a "change in the Department's interpretation of a listed tax... retroactively if the change would increase a taxpayer's liability for a listed tax." As additional authority, Taxpayer cites to Letter of Findings 04-20140145 (August 1, 2014), 20140827 Ind. Reg. 045140316NRA, in which the Department "agreed that it could not take away a taxpayer's exemption because it had been allowed that exemption in a prior audit." In that ruling, the Department found that even though the taxpayer "cannot be said to qualify for the exemption after further review the fact that [the taxpayer] had claimed an exemption for these items in question for several years with the Department's prior approval through two audits, leads to the conclusion that [the taxpayer] should be permitted the exemption for these items for the tax years in question."

Taxpayer provided a history of its Indiana tax filings on the ground that the history was relevant in addressing its most recent protest.

Taxpayer stated that it had previously filed 1997 through 2000 Indiana tax return in which it reported its income on a combined basis. In 2002, the Department's audit of those returns disallowed that combined filing methodology. Taxpayer protested that decision and, although no administrative decision was ever issued, the Department and Taxpayer agreed to settlement terms under which Taxpayer was permitted to file on a standard, consolidated basis.

The Department conducted a second audit in 2005. That second audit accepted Taxpayer's consolidated filing for the years governed by the settlement agreement and the subsequent 2003 year.

Thereafter, Taxpayer continued to file on a standard, consolidated basis for 2004 through 2011.

The current audit reviewed 2009, 2010, and 2011 concluding - as stated in the audit report - that Taxpayer should file on a "consolidated separate accounting basis to fairly reflect Indiana source income." The report explains,

"[A]djusted gross income was done as if each affiliate filed separate returns. The adjusted gross income for each affiliate was computed using its own apportionment factors."

Taxpayer states that this conclusion and the pending assessment is contrary to the Department's own prior interpretation of the law because Taxpayer was permitted to file on a standard, consolidated basis for 2003 and previously. According to Taxpayer, the Department could have challenged that filing method at that time. Having failed to do so, the Department is obligated to permit Taxpayer a standard, consolidated filing methodology until, at least, until Taxpayer is given proper, prospective notice.

## 6. Fairly Reflect.

Taxpayer asserts that the Department's "consolidated separate accounting" methodology "does not produce a fair reflection of [Taxpayer's] income." Taxpayer explains:

[Taxpayer] is a multi-state, multi-corporate enterprise that derives income from the operation of its business as a whole. Accordingly, the use of separate accounting (which is what the auditor says he is applying) to attribute certain income of [Taxpayer's] consolidated return to Indiana because it fails to account for contributions to income and losses resulting from the overall multistate business.

As an example, points out that Company A - Taxpayer's parent group - "provides finance, human resource, information technology, treasury, and corporate strategy services to multiple entities included in the Indiana consolidated returns . . . which are unaccounted for using the separate accounting method." Taxpayer concludes that the Department's separate accounting of its twenty entities' factors does not fairly represent the consolidated group's true Indiana source income.

# C. Hearing Analysis.

The audit arrived at its decision requiring that Taxpayer calculate its members' tax on a "consolidated separate accounting basis" pursuant to authority found at IC § 6-3-2-2(I) and (m). IC § 6-3-2-2(I) states:

If the allocation and apportionment provisions of this article do not fairly represent the taxpayer's income derived from sources within the state of Indiana, the taxpayer may petition for or the department may require, in respect to all or any part of the taxpayer's business activity, if reasonable:

- (1) separate accounting:
- (2) for a taxable year beginning before January I, 2011, the exclusion of any one (1) or more of the factors, except the sales factor:
- (3) the inclusion of one (1) or more additional factors which will fairly represent the taxpayer's income derived from sources within the state of Indiana; or
- (4) the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income. (Emphasis added).

IC § 6-3-2-2(m) authorizes the Department to resort to alternative methods of reporting income:

In the case of two (2) or more organizations, trades, or businesses owned or controlled directly or indirectly by the same interests, the department shall distribute, apportion, or allocate the income derived from sources within the state of Indiana between and among those organizations, trades, or businesses in order to fairly reflect and report the income derived from sources within the state of Indiana by various taxpayers.

As noted previously, Indiana law permits affiliated groups of corporations to report their income on a consolidated basis and permits separate accounting of the group's factors.

For illustrative purposes only, the following examples are provided. In these examples, "percent" is abbreviated as "PC." The first example illustrates "simple" consolidated reporting of four theoretical businesses ("A, B, C, D"). The calculation begins by adding the companies' income and losses, calculates a combined apportionment percentage for all four companies, and multiplies that overall apportionment percentage by the four companies' total income.

| Companies:              | Α     | В     | С      | D        |                                  |
|-------------------------|-------|-------|--------|----------|----------------------------------|
| Separate Income         | \$200 | \$300 | \$400  | -(\$400) | = \$500                          |
| Separate Apportionment: | 50 PC | 70 PC | 100 PC | 60 PC    | = 70 PC (consolidated percent)   |
| Total Indiana Income:   | \$140 | \$210 | \$280  | -(\$280) | = \$350 (consolidated IN income) |

The four companies' taxable consolidated Indiana income is \$350 (70 PC times \$200, \$300, \$400, and - (\$400)) under a "standard" apportionment calculation. In this scenario, the impact of the loss is relatively proportional to D's Indiana's presence.

The first example is compared to a second example in which one affiliate ("D") has an insignificant Indiana presence combined with significant losses in a consolidated group.

| Companies:              | Α     | В     | С      | D        |                                  |
|-------------------------|-------|-------|--------|----------|----------------------------------|
| Separate Income:        | \$200 | \$300 | \$400  | -(\$400) | = \$500                          |
| Separate Apportionment: | 50 PC | 70 PC | 100 PC | 4 PC     | = 56 PC (consolidated PC)        |
| Total Indiana Income:   | \$112 | \$168 | \$224  | -(\$224) | = \$280 (consolidated IN income) |

In this second example, the Department might find it justified to employ a separate accounting because "simple" accounting would skew the result by giving disproportionate weight to D's losses. In the above example, D has only a 4 percent Indiana apportionment ratio, but is able to import more than 50 percent of its losses.

On a separate accounting consolidated basis, the consolidated income is computed on a company-by-company basis with the taxable income being the sum of those separate calculations. This method may eliminate situations where an affiliated entity with minimal Indiana presence skews the consolidated group's income. In other words, the losses reported are proportionate to the loss entity's Indiana activities.

| Companies:                 | Α     | В     | С      | D                                |
|----------------------------|-------|-------|--------|----------------------------------|
| Total Income:              | \$200 | \$300 | \$400  | -(\$400)                         |
| Apportionment Percentages: | 50 PC | 70 PC | 100 PC | 4 PC (no consolidated PC)        |
| Total Indiana Income:      | \$100 | \$210 | \$400  | -(\$16)= \$694 (total IN income) |

These three A, B, C, D examples illustrate how "simple" and separate accounting functions. The examples demonstrate that in certain situations, employing the "simple" apportionment method allows a member of a consolidated group to import disproportionate losses (compared to that entity's Indiana activities) into Indiana. When this happens, the Department has the statutory authority to employ other methods, such as separate accounting, to reapportion the income to fairly reflect the consolidated group's actual Indiana presence.

Taxpayer challenges the audit's explanation on the ground that the report obfuscates the justification "by calling [the audit's] method a 'consolidated separate accounting' method" rather than calling the approach a supposedly disfavored "stacked" calculation. The Department finds the Taxpayer's criticism unwarranted. There is no distinction between "consolidated separate accounting," "separate accounting," and "stacked" accounting; they are simply one-and-the same. Whether the audit report cites to "consolidated separate accounting," "stacked" accounting, "pre-apportionment (simple)," or "post-apportionment (stacked)" is irrelevant because the labeling is a distinction without a difference. In this case, the choice of calculation results in an increase in the amount of Taxpayer's taxable income, but the choice is not the denial of Taxpayer's right to file and report the income and apportionment of its twenty business entities on one, single consolidated return. Taxpayer retained the primary benefit of filing on a "consolidated" basis which is the elimination of intercompany transactions.

Taxpayer argues that the Department is denying the Taxpayer the "privilege" of filing a consolidated return as guaranteed under IC § 6-3-4-14. ("An affiliated group of corporations shall have the privilege of making a consolidated return . . . ."). The Department must disagree. The audit did not deny Taxpayer the privilege of reporting its income on a consolidated basis; the audit disagreed on how to best, most accurately calculate the individual entities' losses and gains. Taxpayer's privilege of filing a consolidated return is untouched.

Taxpayer maintains that the Department's most recent audit resorts to a remedy which is not authorized under Indiana law. The Department disagrees because "separate accounting" is an alternative specifically authorized under IC § 6-3-2-2(I)(1).

Taxpayer claims that it was entitled to rely on the prior 2004 settlement agreement (addressing 1997 through

2000) and the results of a prior 2005 audit which addressed 2003 and prior years. Taxpayer concludes that the Department may not now require an alternative calculation mid-stream. Taxpayers are, of course, entitled to consistency in its treatment of taxpayers and in its interpretation and application of the law. However, Taxpayer has not pointed out how the facts and circumstances in the prior audit were identical or similar to those in the current audit or whether the audit prior addressed any of the concerns which arose in this most recent audit.

In addition, the Department reminds Taxpayer of the principle that "each assessment and each tax year stands alone." Miller Brewing Co. v. Indiana Department of State Revenue, 903 N.E.2d 64, 69 (Ind. 2009). A review of the 2005 audit report and the 2004 settlement agreement finds no assurance that the Taxpayer will be justified in filing a consolidated return calculating the twenty entities' Indiana source income on a "simple," non-stacked basis. In other words, there is no agreement on the going forward treatment of the Taxpayer's Indiana income.

Taxpayer states that the Department's current audit's conclusions violates the three-year statute of limitations for assessing additional tax as set out in IC § 6-8.1-5-2 because the audit recalculated Taxpayer's 2004 through 2008 returns and disallowed NOLs garnered during those years. IC § 6-8.1-5-2 precludes the Department from issuing a "proposed assessment" "more than three (3) years after the latest of the date the return is filed or . . . the due date of the return." However, the Department finds no basis for Taxpayer's challenge because the Department has not assessed tax attributable to 2004 through 2008. The Department's audit recalculated Taxpayer's prior NOLs which - admittedly - will almost certainly have an effect on Taxpayer's subsequent year Indiana tax liability but does not cross the bright line which precludes the Department from issuing an assessment more than three years after the date Taxpayer's 2004 through 2008 returns were filed or the date those returns were due. The NOL deductions at issue were taken on the 2009, 2010, and 2011 returns which were the years under legitimate audit consideration. The only proposed assessments are attributable to those years.

At the administrative level, the Department is reluctant - if not unwilling - to address constitutional questions raised by any taxpayer. However, the Department finds little support for Taxpayer's assertion that the "separate accounting provision" or application of that provision violates the Equal Protection Clause. The Department notes that the "separate accounting" provision has been an integral part of the Indiana's adjusted gross income tax provisions since 1963 and has successfully withstood any challenges to its validity or constitutional legitimacy for the past fifty-two years. 1963 Acts (s) ch. 32, § 204. The IC § 6-3-2-2(I) "separate accounting" provision is a long-standing, legitimate, non-discriminatory alternative intended to assure that multi-state and multi-party taxpayers pay their fair share of Indiana tax.

Finding that the Department is statutorily entitled to require taxpayers to file on a "separate accounting" basis, that the Department is entitled to recalculate Taxpayer's 2004 through 2008 NOLs on a "separate accounting" basis, the question remains as to whether the Department was justified in resorting to that alternative methodology. The Department clearly may not employ "separate accounting" merely because that calculation increases a taxpayer's liabilities. As Taxpayer correctly explains in its protest, the Department may not resort to "stacked" accounting "simply because NOLs reduce taxable income and/or there are large denominators . . . . ."

As pointed out by Taxpayer in its citation to the Wabash decision, "The Department has reiterated its preference for the standard method . . . in rulings where the taxpayer sought to use the stacked method. Wabash, 729 N.E.2d at 625. The Department agrees when the court states that "the standard formula is the most accepted and recognized method of computing a company's taxes." Id. However, the Wabash decision also noted that "[s]sufficient differences in the method of doing business may be justification for separate classification and differential tax treatment." Id. at 626. (Emphasis added).

The lesson from Wabash is that both the law and the Department favor the standard, "simple" consolidated calculation "unless the Department proves that the income attributed to Indiana from using that formula is out of proportion to the business transacted in Indiana." Id. at 625. The issue is whether - as reflected on the original consolidated return - did the standard, simple calculation distort Taxpayer's Indiana source income?

As explained in the audit report, more than half of the Indiana reporting entities were small, very profitable companies but the Taxpayer's consolidated returns consistently reported NOLs for the years 2003 through 2011. The NOLs reported by companies with relatively minimal ties to Indiana - Company A, Company B, and Company C - eliminated all the taxable income of the Indiana affiliates with 100 percent Indiana apportionment. That overall loss position was attributable to the inclusion of Company A, Company B, and Company C each of which - according to the audit report - "had only several million dollars of actual Indiana losses." As stated in the audit report: "The net effect of Taxpayer's approach would have been to 'import' substantial losses generated outside Indiana into Indiana." (But see Letter of Findings 02-20130268 (February 4, 2014), 20140924 Ind. Reg. 045140355NRA , In which the Department found that the audit's review and adjustment of the taxpayer's prior

years NOLs was not "reasonable," not based on "any analysis," but that the taxpayer incurred legitimate interest expenses, and properly deducted those expenses in arriving at its federal taxable income . . . . ")

Those losses were legitimately a factor in the calculation of the Taxpayer's Indiana source income but simply not in the manner or the degree by which Taxpayer arrived at its original calculation. However, the "privilege" of filing consolidated returns is that only one entity is required to file the return, but that "privilege" should not be construed as a method of computing taxable income. There is no evidence of an "abusive tax scheme" on the part of Taxpayer, but Taxpayer's original calculation had the effect allowing the unprofitable factors to drown out the factors of the profitable factors and was entirely out of proportion to the three loss companies' minimal Indiana ties.

In this case, the numbers speak for themselves and the audit was justified in resorting to a "separate accounting," as permitted under Indiana law, in order to correct the distortive effect of the Taxpayer's original filings and therefore fairly reflect Taxpayer's Indiana income. Taxpayer has failed to meet the statutory requirement of establishing that the "separate accounting" recalculation yielded a result which was "wrong." IC § 6-8.1-5-1(c).

#### **FINDING**

Taxpayer's protest is respectfully denied.

## II. Tax Administration - Underpayment Penalty.

#### **DISCUSSION**

Taxpayer objects to the Department's imposition of a ten-percent underpayment penalty.

IC § 6-3-4-4.4(c) imposes on each taxpayer the responsibility to calculate and pay a "declaration of estimated tax for the taxable years" if the amount of that estimated is more than \$1,000. Id.

Every corporation subject to the adjusted gross income tax liability imposed by this article shall be required to report and pay an estimated tax equal to the lesser of:

- (1) twenty-five percent (25[percent]) of such corporation's estimated adjusted gross income tax liability for the taxable year; or
- (2) the annualized income installment calculated in the manner provided by Section 6655(e) of the Internal Revenue Code as applied to the corporation's liability for adjusted gross income tax.

IC § 6-3-4-4.1(d) imposes a penalty if a taxpayer fails to pay the correct amount of estimated tax.

The penalty prescribed by <u>IC 6-8.1-10-2.1(b)</u> shall be assessed by the department on corporations failing to make payments as required in subsection (c) or (f). However, no penalty shall be assessed as to any estimated payments of adjusted gross income tax which equal or exceed:

- (1) the annualized income installment calculated under subsection (c); or
- (2) twenty-five percent (25[percent]) of the final tax liability for the taxpayer's previous taxable year. Id.

IC § 6-8.1-10-2.1(a)(3) requires that a ten-percent penalty be imposed if the under-estimate results from the taxpayer's negligence. IC § 6-8.1-10-2.1(a)(2) requires a ten-percent penalty if the taxpayer "fails to pay the full amount of tax shown on the person's return on or before the due date for the return or payment."

IC § 6-8.1-10-2.1(d) states that, "If a person subject to the penalty imposed under this section can show that the failure to . . . pay the full amount of tax shown on the person's return . . . or pay the deficiency determined by the department was due to reasonable cause and not due to willful neglect, the department shall waive the penalty."

Departmental regulation <u>45 IAC 15-11-2(b)</u> defines negligence as "the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer." Negligence is to "be determined on a case-by-case basis according to the facts and circumstances of each taxpayer." Id.

Departmental regulation 45 IAC 15-11-2(c) requires that in order to establish "reasonable cause," the taxpayer must demonstrate that it "exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed . . . . "

Under IC § 6-8.1-5-1(c), "The burden of proving that the proposed assessment is wrong rests with the person

against whom the proposed assessment is made." An assessment - including the underpayment penalty - is presumptively valid.

Taxpayer believes it is entitled to abatement of the penalty. Taxpayer states, "Any deficiency ultimately determined to be owed by [Taxpayer] is not due to [Taxpayer's] negligence or intentional disregard of the tax laws or regulations." Instead, "[Taxpayer has made every effort to comply with proper tax reporting and payment requirements and believes that it has in good faith on a reasonable basis interpreted and applied Indiana's tax laws in the preparation of its returns." In particular, Taxpayer argues that it prepared its tax returns "in accordance with its good faith, reasonable interpretation of the standard consolidated basis allowed by the Department in the prior audit of the 2003 year."

Upon review, the Department is in agreement with Taxpayer's assertion that it did not act negligently or fail to exercise the judgment "as would be expected of an ordinary reasonable taxpayer." 45 IAC 15-11-2(b). Whatever disagreement the Department may have with the Taxpayer's method of preparing its original returns and calculating its tax liability, there is sufficient evidence to agree with Taxpayer that it "exercised ordinary business care and prudence . . . . " in preparing those original returns. 45 IAC 15-11-2(c).

Based on a consideration of the relevant "facts and circumstances," Taxpayer has met its burden of establishing that the penalty should be abated.

#### **FINDING**

Taxpayer's protest is sustained.

#### **SUMMARY**

Taxpayer has failed to establish that the stacked method of calculating the individual entities included in its consolidated return was wrong. Taxpayer is entitled to abatement of the ten-percent "underpayment" penalty.

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